

Mongolian Banking System Human Resources Evaluation and Action Plan

Executive Summary

March 2000

The Mongolian banking system has undergone a number of bank failures and crises in recent years, and can best be characterized as fragile. Myriad factors, including a weak economy, lack of banking and credit skills, poor management, ineffective regulation, lack of liquidity, and an inadequate legal system, are responsible for the banking system's problems, and most of these issues are not resolved yet. The World Bank is considering a Financial Sector Adjustment Credit for Mongolia, but has asked for the Bank of Mongolia to adopt an action plan to address banking and supervisory skills, accounting and audit standards, governance, and enforcement of financial contracts.

This study makes recommendations concerning the human resources aspects for the Bank of Mongolia's action plan. Two consultants spent three weeks meeting with commercial bankers, representatives of the Bank of Mongolia, ministry officials, donors and others, to develop a background report and recommendations in the following areas:

- Governance
- Bank Regulation
- Credit
- Internal Control (Audit)
- Legal
- Accounting
- Human Resources
- Banking Association
- Systems
- Customer Service and Marketing
- Treasury
- International
- Banking Services in Rural Areas
- Non-Bank Financial Institutions

To build a strong banking system the Bank of Mongolia and the Government of Mongolia need to commit to and take a series of actions to raise the performance standards expected of the commercial banks, and of the Bank of Mongolia itself. In human resources terms, **training** is the major tool that can be used to assist the banks to meet these standards. The Mongolian banking system has received a lot of training in the past, particularly in credit subjects, but this seems to have had a negligible effect on the quality of loans and bank management. We believe that this has occurred because training has been offered in a vacuum, and too far in advance of possible implementation in the banks. Training is only effective if skills learned can be immediately practiced. While a great deal of training, as well as development and revision of courses, is recommended, it is always in the context of supporting other actions. The measurement of benefit of training will come through the Bank of Mongolia examination process, both in the assessment of personnel qualifications (i.e., do staff have the appropriate education and training for their responsibilities) as well as in assessment of bank performance itself, e.g., fewer problem loans, but problems anticipated.

The subject of **training capacity** also warrants attention, as it is important to have an institutionalized source of training in the country. Too frequently in the transitional economies, training seems to be tied to the life of a donor project, and despite project

intention the training capacity tends to wither and die after the project closes. The team reviewed the operations of the Banking Training Center (BTC), which is operated under the auspices of the Bank of Mongolia, and which does offer a regular set of classes. While the banks are looking for quality improvement and a wider range of offerings, in general they speak well of the BTC. We are recommending that the Bank of Mongolia ensure that the BTC is institutionalized, and that all training be channeled through the BTC, since it is an existing organization with some standing. This eliminates the problem of having to create a new entity to take responsibility for training.

As the Bank of Mongolia tightens up regulatory requirements, the BTC would revise or create courses to meet the training support that bank personnel will need to comply to higher standards. In this sense courses will not be created in a vacuum, but will have a professional aim in mind. There will also be a better opportunity for feedback about the efficacy of courses, since the Bank of Mongolia will be examining for stronger skill sets. In some cases the BTC may wish to bring in an outside subject expert to ensure that material is accurate, up to date, and relevant. We also recognize that the BTC does not have the resources to immediately increase the quality and offerings in all subjects. It is more appropriate for the BTC to follow the Bank of Mongolia's schedule than for it to be creating its own timetable: as noted above, training is a part of the whole learning process, and is not effective in a stand-alone basis.

One major aspect of the institutionalization of the BTC is its funding. While we are recommending that the Bank of Mongolia commit to whatever financial support of the BTC is necessary, we do believe that it should eventually operate on a cost-recovery basis, and that course fees should gradually be increased to ensure this. We believe that higher fees will also have the benefit of increasing the effectiveness of training, as both the banks and the bankers will more highly value, and put more effort into, something that costs them more. It is appropriate for the banks to consider that training is not a privilege or a gift: it is a cost of doing business. As with all expenses, it is either expected to make or save more money than the cost expended. Using this analysis, banks will expect strong performance from their employees who take courses, and will also be demanding about the quality of courses that are being presented.

On the job training is also a significant learning tool. As discussed elsewhere, we have put a heavy emphasis on the need to put resources into strengthening the Bank of Mongolia supervisory capacity. In addition to the need for a stronger supervision process itself, attention to the supervisory capacity has a leverage effect on the banks, since a proactive examination can be a tremendous learning tool for the banks.

The first section of this report is a matrix which includes a statement of the problem, recommended action and steps to be taken to remedy or mitigate the problem, training which would support the corrective action, and the **Results** expected. Recommendations for action are classified as short term, or within the year; medium term, by 2005; and long term, by 2010. This is followed by a narrative discussion of findings in each of the areas listed above. Although all of these are key areas, we believe special attention should be

paid to **Governance, Regulation, Credit, and Internal Control**. This summary additionally comments on findings in the other key areas.

Governance

Over the past few years, poor governance has led either directly or indirectly to several bank failures. In most transitional economies, good governance is invariably lacking and the situation in Mongolia is no different. Consequently, there are many opportunities for insider trading available to business people, who generally do not have a great deal of personal wealth. Not surprisingly, many of those in positions of authority have chosen to enrich themselves and their friends at the expense of their organization and ultimately their country. This has been made easier since the rules and regulations in place to prevent such activity have been ineffective. Stricter legislation to prevent self dealing has now been enacted but to date, the implementation has been weak. The proposals that we have offered in the Action Plan are designed to hold bank directors and senior bank executive more accountable, but they could just as well apply to all business people. We believe an effective response to the lack of governance in banking circles is education on governance and banking issues, coupled with stricter enforcement. Good governance also includes the ability to provide direction and leadership, as well as ensuring that a high level of integrity is in place. Consequently, the Bank of Mongolia should screen bank directors and senior bank executive more carefully to ensure that they are competent business people as well possessing the desired level of integrity required to perform their role. We are recommending that two separate courses should be offered; one on governance issues and the other on good banking practices. These courses should be designed and presented jointly by the Bank of Mongolia and the Ministry of Justice.

Regulation

An inadequate regulatory process was one of the reasons for some the recent bank failures. In the past, bank examinations have been a passive exercise with the emphasis placed on checking transactions without focusing attention on early warning signals which anticipate problems. Because of the recent bank failures, together with the absence of a deposit insurance scheme, it is not surprising that most Mongolians do not trust their banks. This is illustrated by the fact that the ratio of activity conducted by the banking industry in relation to GDP, is one of the lowest in the world.

In an effort to improve regulation techniques, the Bank of Mongolia has improved its examination procedures and has sent its staff to regulatory training courses presented by foreign central banks. This should continue as the experience gained by the examiners is very valuable. We also recommend that the Bank of Mongolia engage foreign regulators to assist with the bank examinations since it will be a good learning process for both the local examiners and the staff of the bank being examined. An extension of this process would be for the Bank of Mongolia to engage a regulatory expert on a retainer basis, who would travel to Mongolia from time to time, to advise on regulatory practices in addition to giving seminars to local examiners.

We have proposed several training programs and seminars which cover not only Bank of Mongolia staff, but also attempts to include a wider audience in an effort to bring about a greater understanding of the banking system generally. This is important since there is little understanding of the Bank of Mongolia's function among politicians, particularly as it relates to a more independent role.

Credit

Poor risk assessment by bank lenders and poor credit decisions by senior bank management has led to significant loan losses. The lack of an effective credit policy in Mongolian banks has compounded the situation. In addition, a lack of understanding of banking practices in a non-socialist economy by the directors has meant that senior bank management has not been adequately held accountable for their activities. There are several steps which can be taken to improve the current situation. As a priority, the Bank of Mongolia must establish a minimum criteria for bank credit policy. We have indicated those areas within the sphere of credit activity which are of major importance and should be addressed as part of credit policy. If the Bank of Mongolia is not satisfied with a bank's revised credit policy, it should point out the shortcomings and establish a specified period of time for the bank to bring them up to the required level. Once the credit policy has been established, the Bank Training Center, together with the Bank of Mongolia examiners and the banks, should conduct a full review of credit course material to ensure that it is relevant to the current needs. The revised course material should then be presented to bank directors as an adjunct to the course on governance recommended above. The end result of this process will be the establishment of a sound credit culture which Mongolian banks currently lack.

The new credit risk rating procedures developed by the Bank of Mongolia, deal only with past due loans. They do not include performing loans, many of which will be the bad loans of the future. In order to provide for early warning signals for future bad loans, we have recommended that banks implement an objective credit risk rating system to measure the quality of the whole portfolio on an ongoing basis. Objective credit risk rating procedures are the cornerstone of an effective management information system which the directors and senior management need to monitor portfolio trends.

Banks have generally not been able to maximize value when liquidating bad loans. This is due to lack of experience in dealing with "work outs" as well as an unfriendly legal environment in the liquidation of collateral. Firstly, we have recommended that a new course be provided to bank credit personnel involved in "work outs" based on the case study approach. Existing bad loans would be used to develop the case studies. Secondly, in an effort to improve the climate in which to liquidate collateral, we have recommended that the BELTAC project, which will expire in April, be replaced with a new program which should place emphasis on training all stakeholders, not just the bank personnel, in the new Mongolian commercial law.

Internal Control

Current bank control programs are ineffective since they are not proactive but are essentially passive in that they concentrate on checking historic data for accuracy. It is important to emphasise that the whole approach must change to make the procedure more effective. The Bank of Mongolia has an important role to play in setting the criteria for internal control procedures which Mongolian banks should follow. It will probably be necessary for the banks to seek the advice of their external auditors in order to meet the Bank of Mongolia's internal control criteria. Bank staff will require specialized training from their external auditors and/or the Bank Training Center in order to become familiar with the new procedures.

As a separate process, banks need to develop an internal credit review procedure on a regular basis to ensure that risk ratings are accurate and that management have a true picture of portfolio quality.

There must also be a procedure to ensure that serious governance irregularities which surface as a result of internal control audits, are reported to the authorities. This may prove difficult since internal control personnel report to the very people, senior management and bank directors, who may have violated the rules. Consequently, bank personnel must be encouraged to report such irregularities to their external auditor or to the Bank of Mongolia if no action has been taken.

Legal

There is a general lack of understanding of the new Mongolian commercial law system. This is understandable since there have been such massive changes to the system during the past few years. The BELTAC project was meant to assist with the transition but its performance has been somewhat disappointing and there are still a large number of stakeholders including judges, prosecutors, police, university law professors and others, including bankers, who are not familiar with basic details. The effect of this lack of knowledge of the legal system means that while the legislation may be in place, the execution is extremely weak. We have recommended that a successor project to BELTAC be established with the specific task of disseminating details of the new legislation to all the stakeholders. In addition, special attention should be paid to bailiffs and other people who are responsible for the physical execution of judgements and court decisions. Special instruction and adequate compensation to all those involved including judges, will be necessary if the current problems are to be alleviated.

Accounting

Banks need to have reliable financial statements in order to make good financial decisions. While International Accounting Standards (IAS) have been adopted, implementation has been slow. The Bank Training Center should continue to offer courses in IAS as a way to increase the awareness among bankers that such information is important for accurate financial analysis techniques.

Banks need to establish criteria to ensure that financial statements meet IAS when presented by borrowers to support loan applications and reviews. Realistically, smaller companies will not provide financial information based on IAS and standard financial statements based on tax statements for such borrowers need to be developed. The Bank Training Center should develop a course for analysing small borrower information on this basis.

Human Resources

Banks need to demonstrate that banking is a good career if they are to attract the best personnel. This means that banks need to develop an attractive career path for their personnel coupled with a competitive compensation program. In particular, senior management need to have meaningful compensation packages to include both monetary and non-monetary benefits. Directors should receive a fee for attending director's meetings. Such compensation benefits are necessary if a serious attempt is to be made to improve the level of governance.

In order that universities produce graduates with the skills required by the banking industry, a continual dialogue should be maintained between these two parties to ensure this occurs. The process will be enhanced by increasing the number internships available to students at the banks. Also, an executive education program at universities, geared to seasoned bankers, would be valuable. In the longer term, banking careers should be seen to be more prestigious if a professional designation is established as discussed under the Bankers' Association section.

Self dealing by staff threatens profitability and indeed the viability of banks. Therefore, it is essential that a board approved code of conduct be introduced by all Mongolian banks. In house training will be needed to explain the new code and enforcement of violations should be vigorously pursued.

Bankers' Association

Mongolian banks lack a forum to exchange ideas and to promote the interests of the industry to government and the public in general. In addition, there is a need for an independent body to take charge of bank training. These roles are currently performed by the Bank of Mongolia which has filled the vacuum. Once an association is well established, it should take over these functions and additionally, develop a program to provide for specific diplomas and a professional designation to enhance the careers of Mongolian bankers.

Systems

Current accounting systems are generally adequate for day to day work processing needs but lack the ability to provide good management information. The ADB is sponsoring the installation of a loan accounting software program which should be implemented in six banks over the next year. Once installed, this should alleviate many of the shortcomings

with the existing bank accounting systems. It is important that to the extent possible, management information systems which are a part of the package, be used by senior management. Training to use this material effectively will be necessary.

An appropriate loan analysis software package is also necessary as banks move into the next phase of lending against cash flow. Also, a reliable loan data base is will be required.

The Bank of Mongolia is currently responsible for the Credit Information Bureau. In the long term, this should be divested and owned by a consortium of Mongolian banks on a cost recovery basis.

Customer Service

Marketing

Treasury

International

Non-Bank Financial Institutions

These services are largely underdeveloped in Mongolia. A number of courses are required and we have made some specific recommendations which if enacted, will ensure that Mongolian banks will have their people trained in these areas to meet customer needs.

Banking Services in Rural Areas

Mongolia is a vast under populated country with a poor communications infrastructure. Consequently, it is very difficult to provide an acceptable level of banking services to the rural population. From the point of view of training bankers to provide these services, the best approach in the longer term is to develop a system of distance leaning as technical and communications applications improve. The situation should be closely monitored by the proposed bankers' association to ensure that training applications can be provided as soon as practical. In the meantime, it may be possible to provide instruction in the larger aimag centers, as well as through the use of CD-ROM material.